

Summary of Iowa Nonprofit Corporation Directors' Duties

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Both the Revised Iowa Nonprofit Corporation Act (“Revised Act”) and case law impose certain duties on directors of nonprofit corporations. Under the Revised Act, directors are responsible for managing the affairs of the corporation. As such, the Revised Act (and case law) imposes obligations on them in the form of the duty of care and a duty of loyalty. In addition, courts have recognized a third duty – the duty of obedience. The following is a brief summary of these duties. This summary is not meant to prescribe the exact manner in which directors must act in all situations. For additional information, you should consult your organization’s attorney.

Duty of Care

While the Iowa Nonprofit Corporation Act, the predecessor to the Revised Act, did not expressly address the duty of care, the Revised Act recognizes such duty and requires that each member of the board of directors of the corporation, when discharging the duties of a director, act in good faith and in a manner that the director reasonably believes to be in the best interests of the corporation. Iowa Code section 504.831(1).

The duty of care includes two main functions -- decision-making and oversight. In terms of decision-making, which is usually in the form of voting on a matter, each director needs to have sufficient information to be able to make an “informed” vote.

The oversight function relates to the board’s responsibility for monitoring the operations of the organization. This means, among other things, that a director should have a general knowledge of the nonprofit corporation’s operations and be aware of what the financial records disclose and take appropriate actions to make sure there are proper internal controls, including compliance programs. A director also should make reasonable inquiry in appropriate circumstances such as when there is troubling or unclear activity. In addition, a director, upon becoming aware of warnings or reports of officer or employee theft or mismanagement, should ensure that a proper investigation is made and action taken.

The duty of care involves active participation in the organization. This means that a director should regularly attend meetings of the board and board committees, enter into discussions at such meetings when appropriate, evaluate reports, read minutes (which should be taken at every board and committee meeting), learn about the organization’s programs, and review the performance of the executive director and the organization’s budget.

A director who is present at a meeting when action is approved by the board is presumed to have agreed to the action unless the director objects to the action.

In carrying out the duty of care, a director may rely upon others – including committees of the board of directors, lawyers, accountants and other experts – and delegate if the reliance is in good faith, unless the director knows or should know that such reliance is unwarranted.

Many states, including Iowa, have adopted the Uniform Management of Institutional Funds Act, which applies to incorporated or unincorporated organizations organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes. See, e.g., Iowa Code Chapter 540A. Under the Act, the following standard of conduct is required with regard to the management of a nonprofit's institutional funds:

In the administration of the powers to appropriate appreciation, to make and retain investments, and to delegate investment management of institutional funds, members of a governing board of an institution shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. In so doing they shall consider long-term and short-term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.

Iowa Code section 540A.7.

Duty of Loyalty/Conflict of Interest

A director is required to exercise his or her power in the interest of the nonprofit corporation not in his or her own interest or the interest of another person or entity. As a result, a director should avoid using his or her position in a manner that would result in pecuniary gain for the director or a member of the director's family. The duty of loyalty can be viewed as covering both conflict of interest and corporate opportunity situations.

Conflict of interest transactions are not necessarily prohibited for a nonprofit corporation. In fact, they may be beneficial because a director may be able to offer a good or service to a nonprofit corporation at no charge or at a price that is below fair market value. Still, conflict of interest transactions can be detrimental to a nonprofit corporation when it pays for a good or service in an amount that exceeds a fair price or advantages the director to the detriment of the organization. As a result, it is important that conflict of interest situations be managed through a process that helps prevent directors from taking advantage of the entity as a result of their position on the board.

The Revised Act provides the following “safe harbor” for handling these situations: A conflict of interest transaction is not voidable by the corporation on the basis of the director's interest in the transaction if the transaction was fair at the time it was entered into or is approved as follows:

- The material facts of the transaction and the director's interest are disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee (excluding any interested directors) authorized, approved, or ratified the transaction; or
- If the organization has voting members, the material facts of the transaction and the director's interest were disclosed or known to the members that (excluding any interested members) authorized, approved, or ratified the transaction.

Iowa Code section 504.833.

As noted above, under certain circumstances, a transaction between a nonprofit corporation and its director (or an entity in which the director has a financial interest) may be acceptable and beneficial to the corporation. In order to allow (and protect such types of transactions from challenge), the process set forth above should be followed. This can be accomplished through a conflict of interest policy or bylaws provision that incorporates the requirements set forth above. A policy also might require that the interested board member be excluded from participation in the approval process. For any transaction involving a conflict of interest, it is important that the process followed by the corporation in handling the matter be documented in the minutes of the meeting.

The second type of situation that might involve the duty of loyalty is when a director becomes aware of an opportunity made available to the corporation that the director would like to pursue for his or her own personal benefit or the benefit of others unrelated to the entity. A director who engages in a transaction that the director should reasonably know may be of interest to the corporation should disclose the transaction to the board of directors in sufficient detail and in adequate time to enable the board to act or decline to act with regard to such transaction.

Iowa law also provides that no loans shall be made by a corporation to its directors or officers. Any director or officer who assents to or participates in the making of any such loan shall be liable to the corporation for the amount of such loan until the repayment thereof. Iowa Code section 504.834.

Duty of Obedience

Nonprofit directors and officers have been determined to owe a duty to the purpose (and/or mission) set forth in the entity's organizational documents, such as the articles of incorporation. In addition, directors must comply with state and federal laws that relate to the organization and the manner in which it conducts its business. One reason for imposing the duty of obedience on directors is that donors rely on an organization's faithfulness to its purpose when making donations.

Liability of Directors

The Revised Act includes a provision addressing liability of directors and officers. Under the Revised Act, a director, officer, member or other volunteer is not personally liable in that capacity for any action taken or failure to take any action except liability for any of the following: (1) the amount of any financial benefit to which the person is not entitled; (2) an intentional infliction of harm on the corporation or member; (3) a violation of the unlawful distribution provision; and (4) an intentional violation of criminal law. Iowa Code section 504.901.

Iowa Principles and Practices for Charitable Nonprofit Excellence

In December 2005, the Iowa Governor's Nonprofit Task Force adopted the Iowa Principles and Practices for Charitable Nonprofit Excellence ("Principles and Practices"). The twenty-eight page document, which was specifically written for 501(c)(3) tax-exempt entities sets forth statements of ethical or managerial directions (called "principles") and methods to achieve such principles (called "practices"). The Principles and Practices covers the following subject matter: (1) Role of Charitable Nonprofit Organizations; (2) Starting the Charitable Nonprofit; (3) Mission Statement; (4) Strategic Planning; (5) Board of Directors; (6) Executive Director; (7) Human Resources; (8) Financing and Funding; (9) Communication; (10) Information Technology; (11) Advocacy; (12) Collaboration; and (13) Accountability and Compliance.

The stated purpose of the Principles and Practices is to promote good management practices, ethical conduct and public accountability. While the document itself is not legally binding, it provides direction to charitable nonprofits on many issues, including the duties imposed on directors. The Principles and Practices is available on the websites for the Iowa Secretary of State and Iowa Nonprofit Resource Center.

Sarbanes-Oxley Act

With the passage of the Sarbanes-Oxley Act ("SOX"), commentators have started identifying certain aspects of SOX that they believe should apply to nonprofit corporations in the form of "best practices." It is important to recognize that only two provisions of SOX apply to nonprofit organizations. They relate to the penalties for obstruction of justice, including document destruction, and retaliation against whistleblowers. Nevertheless, commentators have found that the concerns giving rise to SOX have some application in the nonprofit sector.

The American Bar Association's coordinating committee on nonprofit governance issued guidance in 2005 for nonprofits in the form of ten principles. See Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley (ABA 2005). A brief summary of those principles is as follows:

Principle 1: Role of the Board. The organization's governing board should oversee the operations of the organization in such a manner as will assure effective and ethical management. This includes a review of the board's structure and operation to ensure effective oversight.

Principle 2: Importance of Independent Directors. The independent and non-management board members are an organizational resource that should be used to assure the exercise of independent judgment in key committees and general board decision-making. Some of the concerns expressed by the ABA committee relate to deference a board will give to management on issues as well as board culture issues.

Principle 3: Audit Committee. An organization with significant financial resources should have an audit committee composed solely of independent directors that assure the independence of the organization's financial auditors, reviews the organization's critical accounting policies and decisions and adequacy of internal controls system, and oversees accuracy of its financial statements and reports.

Principle 4: Governance/Nominating Committees. An organization should have one or more committees composed solely of independent directors that focus on board governance and board composition issues, including governing documents of the organization and board, the criteria, evaluation and nomination of directors, appropriateness of board size, leadership, composition and committee structure, and codes of ethical conduct.

Principle 5: Compensation Committee. An organization should have a committee composed solely of independent directors that determines the compensation of the CEO and determines or reviews the compensation of other executive officers, and assures that compensation decisions are tied to the executives' performance in meeting pre-determined goals and objectives.

Principle 6: Disclosure and Integrity of Institutional Information. Disclosure by an organization regarding its assets, activities, liabilities and results of operations should be accurate and complete and include all material information. Financial and other information should fairly reflect the condition of the organization and be presented in a manner that promotes rather than obscures understanding. CEOs and CFOs should be able to certify the accuracy of financial and other disclosures, and the adequacy of their organizations' internal controls.

Principle 7: Ethics and Business Conduct Codes. An organization should adopt and implement ethics and business conduct codes applicable to directors, senior management, agents and employees that reflect commitment to operating in the best interests of the organization and in compliance with applicable law, ethical business standards and the organization's governing documents.

Principle 8: Executive and Director Compensation. Executives (and directors, if appropriate) should be compensated fairly and in a manner that reflects their contribution to the organization. Such compensation should not include loans, but may include incentives that correspond to success or failure in meeting performance goals.

Principle 9: Monitoring Compliance and Investigating Complaints. An organization should have procedures for receiving, investigating and taking appropriate action regarding fraud and non-compliance with law or organization policy, and should protect “whistleblowers” against retaliation.

Principle 10: Document Destruction and Retention. An organization should have document retention policies that comply with applicable laws and are implemented in a manner that does not result in destruction of documents that may be relevant to an actual or anticipated legal proceeding or governmental investigation.

Federal Legislation/Panel on Nonprofit Sector

On November 18, 2005, the United States Senate passed the Tax Relief Act of 2005, which includes a package of charitable giving incentives and reforms relevant to the charitable sector. The reforms are generally in close alignment with the recommendations the Independent Sector Panel on the Nonprofit Sector made. The legislation would correct a number of abuses by taxpayers who claim excessive tax deductions and by individuals who use charitable organizations for personal gain. The bill also includes several tax incentives for charitable giving that members of the sector have long advocated.

The Independent Sector established the Panel on the Nonprofit Sector to address the Senate Finance Committee’s proposals. It issued a final report in June 2005. The Panel’s recommendations covered various aspects of nonprofit organizations, including governance issues. These included board compensation (discouraging payment of compensation to board members); executive compensation (incorporating in governance documents a requirement the full board approve annually and in advance the compensation of CEO unless multi-year contracts are in place); travel expenses; structure, size, compensation and independence of governing boards (organization should review board size periodically to determine appropriate size and the positions of the CEO, chair, and treasurer should be held by separate individuals); audit committees (organization should include individuals with some financial literacy on the board of directors); conflict of interest and misconduct (organization should adopt and enforce a conflict of interest policy consistent with the laws of the state and tailored to specific needs and characteristics).

In April 2006, the Panel issued a supplement to its June 2005 final report in which it made additional recommendations addressing international grant making, charitable solicitation, compensation of trustees of charitable trusts, the prudent investor standard, nonprofit conversion transactions, taxation on sales of donated property, consumer credit counseling organizations, disclosure of unrelated business activities, and federal court equity powers and standing to sue. The Panel is continuing to work on the role of self-regulation as contrasted to more government regulation.